



September 2008

Dear Investor,

For those of us who escaped the severe losses in the stock market over the past year sparked by the credit crisis, these last few months have been a tough stretch. Since last year, the basic paradigm of a Fed induced reflation has ruled the markets and more or less defined the relationships between the currencies, stocks, and commodities. However, that reflation paradigm came to a screeching halt in July, and in August a very strong deflationary market environment took hold.

This sudden shift to a deflationary market environment has also produced a once-in-a-decade trend change in the US Dollar. In short, after seven years of relentless declines against most other major currencies, it now appears the dollar has established a new bullish trend. This radically changes the investment landscape we will face going forward, and will require a significant shift in our investment allocations.

This dramatic turnaround in the Dollar has led to declines in our portfolios in July and August, and also during the first week of September. Although our two main portfolios remain in positive territory for 2008, the third quarter will undoubtedly go down as our worse quarter since inception.

Our decline over the past few months has mainly been caused by severe losses in our allocation to investments that have provided a positive counter-balance during the dollar's decline over the past eight years. Since hitting their highs, most commodity indexes have declined 25%-45% over the past several months. Even though we cut back on our energy exposure in July, our remaining allocation to precious metals declined significantly in August.

Although this has been a rough ride over the past few months, whenever the markets go through a paradigm shift of this magnitude there is inevitably a period of transition. Many of the investment themes that provided positive returns over the past eight years will now have to be shelved.

The most important thing for investors to do during market transitions like this is to remain flexible as we make the necessary changes to align your portfolio with the new macro trends as they emerge. In the following pages we'll detail just how the markets have changed, and discuss how we are changing our focus to align ourselves with new environment.

<u>Sitka Pacific Portfolios</u>	<u>August</u>	<u>YTD</u>	<u>Market Indexes</u>	<u>August</u>	<u>YTD</u>
Absolute Return	-4.4%	+5.7%	S&P 500 Stock Index	+1.2%	-12.6%
Hedged Growth	+0.1%	+11.9%	MSCI World (ex USA) Stock Index	-4.9%	-19.0%
Commodities Focus I	-6.0%	-8.9%	HFRX Global Hedge Fund Index	-1.3%	-5.1%
Dividend Growth	+0.0%	-2.0%	Lehman 10-20 U.S Treasury Bond Index	+2.2%	+4.3%

The markets have been at a critical point over the past two months—perhaps more critical than most people appreciate. Since July there has been a rapid unwinding of the market’s basic assumptions about how this credit crisis will evolve, and this shift will likely prove to be the key turning point in this bear market.

Last year at this time, in August of 2007, the Fed began its response to the emerging credit crisis by lowering interest rates and providing new types of credit to banks and other institutions to help cover real-estate-related losses. The market’s subsequent reaction to these moves was underpinned by a few key assumptions: that Fed would be able provide enough credit and stimulus to avoid a collapse of the credit markets, but in the process their actions would severely de-value the US dollar.

In the year that followed, stocks and interest rates declined, the value of the dollar fell 11% against a trade-weighted index of foreign currencies, and commodities rallied significantly—Gold rose from \$650/oz to over \$1000/oz, and Oil doubled from \$70/bl to \$148/bl. The consensus *market* conclusion was that the Fed (and the Treasury) would be able to counter-balance the effects of the credit deflation that was going on in Wall Street and the real economy. This conclusion by the market added fuel to two well-established trends that had been in place for most of this decade: the decline of the US dollar, and the rise of commodities.

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One of the most consistent themes since 2001 has been the decline of the US dollar versus other major currencies. Whether it was against the European Euro, the Australian dollar, or the Chinese Yuan, most major and many minor currencies rose dramatically against the dollar over the past seven years.

There are long-term structural issues in the US economy that have contributed to this decline in the dollar, such as the large trade deficit, the return to budget deficits in 2001, etc. These issues will continue to weigh on the dollar in the decade ahead. In addition, there have been two periods where interest rates in the US declined more than in other major economies, which accelerated the dollar’s decline: rates were lowered to 1% after the tech bubble burst and held there into 2004, and more recently the Fed lowered interest rates to battle the effects of the credit crisis.

The effects of these long-term structural issues and short-term interest-rate differences with other major economies have taken their toll over the past seven years. The US dollar index, which is dominated by the Euro, British Pound, the Canadian dollar and Japanese Yen, declined 40% from its peak in early 2002 through March of this year.

However, in only a few short weeks in August, the dollar began to rally strongly against almost every other major currency and took back all the losses from the over past year—and then some. You can see this gain by the large white candle on bottom right side of the above chart. It was the largest gain in since the dollar bear market began, and it also encompassed a number of key currencies not represented in the dollar index—such as the Russian Ruble and the Brazilian Real.

The Trade-Weighted US Dollar Index



The dollar's rally in August triggered a wholesale liquidation in assets that have done well during the dollar's decline over the past seven years – most notably in precious metals.

Gold declined 9.4% from \$922 to \$835 in August, but the sharpest declines were in silver and mining stocks. Silver declined from \$17.79 to end the month at \$13.70, for a 23% loss. Many of the larger mining stocks followed a path similar to silver, with many of the smaller junior miners fairing even worse.

However, despite the rally in the dollar and the declines in precious metals and commodities, by the end of August it remained up in the air whether this was all just a massive short-covering rally in the dollar that would evaporate just as quickly as it began, or whether it was the start of a durable trend.

In the currency markets, futures data showed that speculative traders had taken their most bullish stance in the dollar since November 2005 – which, as a contrarian indicator, marked the peak of the last bear-market rally. The Euro, the Canadian Dollar and other major currencies had declined to their bull market trendlines, but had yet to break down through them. The declines in gold and silver in August were severe, but no more severe than during a number of previous summer sell-offs we had seen since 2001. Like the Euro, Gold and mining stocks had declined to their bull market trendlines and bounced towards the end of the month – the type of action we had seen a number of times over the course of the bull market.

During each of those previous summer corrections in precious metals it paid handsomely to hold through, because the subsequent rallies often took mining stocks significantly higher during the following nine months. In fact, we saw that exact scenario play out just this past year, as the XAU gold stock index rallied 74% from its August 2007 low to its March 2008 high.

Although it was painful to hold through the precious metals decline in August, at the end of the month the odds – based on market relationships and the fundamental backdrop – still appeared to be in favor of a rebound in precious metals and a turn down in the dollar.



The Canadian Dollar (in blue) and Gold



However, by the first week of September those odds had changed dramatically. Most importantly, the dollar continued its advance against most major currencies, and one by one it became clear that a new bull market in the dollar was taking hold.

Also, currencies such as the Canadian dollar and the Australian dollar, which had been rallying since 2002 with the broader bull market in commodities, began to break their bullish trends against the US dollar. These were clear signals that a significant paradigm shift was underway which would not favor precious metals.

At the same time the dollar was confirming a larger rally in the foreign exchange market during the first week of September, commodities and commodity stocks were signaling that the August decline was not the end of a seasonal correction but the start of a new, larger correction. So far in September, gold and silver have continued their declines, and mining stocks have lost another 23%.

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Investing in the markets is always a process of estimating the odds of a particular scenario playing out, and then allocating your resources to the best risk/reward opportunities. We take that approach seriously, and beyond following the markets' lead, there is no other investment dogma we follow. That means we're going to come out ahead on most actions we take, but it inevitably means we're not going to get every decision correct—that's the nature of the markets. However, in the long run our flexibility to shift to new investment strategies as the market changes is our greatest asset, and now is one of those times that requires a change in every investor's approach.

As stocks have remained at the same level over the past 10 years and Treasury bonds have been range-bound since 2003, inflation and the decline in the exchange value of the dollar have eroded the purchasing power of all our dollar-based portfolios. The only way to combat that erosion over the past seven years has been to invest in non-dollar-based investments such as commodities and foreign markets to seek returns that compensated for the decline in the value of the dollar.

That basic investment theme of emphasizing investments outside the US dollar has been turned on its head over the past two months. The dollar index has rallied over 10% from its low, and some currencies such as the Australian dollar have declined close to 20% - just since July.

In addition, foreign stock markets are now underperforming US stocks for the first time since 2001. The chart to the right shows the MSCI Emerging Markets index versus the S&P 500, and you can see that after seven years of dramatic outperformance, the tide appears to have shifted in favor of US stocks.

Emerging Markets vs. the S&P 500



To some, the idea that the US dollar and US assets are set to outperform most other global markets may seem counter-intuitive, given all the problems we seem to be having in our economy, our housing market and our financial markets. But we have to remember that outperformance is a two-way street: the US may be doing bad at the moment, but it just may be that everyone else is about to do worse than we are.

That sentiment appears to be the major driver behind the dollar rally. While the Fed cut rates early on to address the credit crisis, the European Central Bank and other central banks continued to focus on inflation and kept their short-term interest rates elevated. This policy appears to have had the effect of placing their economies on a track of weaker growth than we have here in the US.

Although we have not seen any official change in interest rate policies in Europe just yet, now that commodities are falling it is becoming more likely that the other major economies will be cutting rates in the foreseeable future as the Federal Reserve hold US short-term rates steady—which is dollar positive.

The likelihood of a continued rally in the dollar, coupled with the prospect of relative outperformance of US stocks versus foreign markets, leaves us with an investment landscape almost completely opposite of what we have faced since 2001.

If this new paradigm continues to strengthen in the months ahead, dollar-based investors will do best by concentrating on their home turf instead of looking outside the US for investments.

In fact, for investors outside the dollar looking into the US, our assets look relatively cheap. Because of the 40% decline in the dollar since 2002, our Treasury bonds reached their lowest level in Euros since 1996 earlier this year.

And although the dollar-denominated S&P 500 is trading near 1200, far above its low near 800 in 2003, in Euros US stocks are right at their 2003 lows—still 50% off their peak reached in 2000.

For foreign investors, who have seen their currencies and stock markets pushed sky high over the past several years and are now seeing their economies

weaken substantially, the US dollar and US assets may be seen as a *relative* safehaven during this global downturn. Although there are many more detailed and country-specific reasons why the dollar could continue to rally from here, this general sentiment of cheap US assets providing a relative safehaven is probably the over-arching theme powering the dollar right now.

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While it appears that US assets have now entered a period of outperformance relative to other markets, that doesn't mean both bonds and stocks are ready to rise from here. It just means that on a currency adjusted basis US stocks will likely lose less than other markets during this bear market, and when stocks are ready to rise we will do better by looking for equity exposure within the US versus looking to foreign markets.

However, until the bear market ends, a rising currency and weakening domestic and global economies leaves dollar-based investors facing an extremely deflationary market environment. With US stocks, foreign stocks, commodities, and foreign currencies all falling together, there is a far smaller range of potential areas to invest in that offer the prospect of positive returns.

Fortunately, we have the flexibility within our portfolios to adapt to this new deflationary market, and also to adjust to a more dollar-centric investment climate—if that is where the market's are heading.

From Outside the Dollar, US Assets Look Cheap



Hedged Growth

In the Hedged Growth portfolio we use quantitative methods to choose which stocks to buy and which stocks to short. These methods look at fundamental measures to assess how particular sectors and companies within those sectors are doing, and it also uses methods to assess how a company's stock is performing.

It's no secret why we have been long various energy stocks over the past few years, because the overall trend in that area of the market has been good. It's also no secret why we have been short a number of financial stocks over the past year. These have been durable trends that have been confirmed by both the price action of the stocks and the fundamentals underlying the entire sectors.

When we go through a significant trend change in the market, or in a specific area of the market, it will take a few months for positions in the portfolio to reflect those changes. That's because Hedged Growth responds to *durable* market trends, and attempts to filter out as much short-term noise as possible. That necessarily means there will be short-term losses during a major shift in the markets until we see that the shift is the start of a real change in trend, and not just a short-term correction.

As we move forward, the positions in Hedged Growth will continue to reflect the over-riding themes driving stocks, both on the long and short side of the portfolio. Coupled with our ability to shift from net long to market neutral, Hedged Growth will continue to do well through this new deflationary market environment.

Absolute Return

In Absolute Return, we have felt the impact of the decline in commodities directly over the past several months. We sold our exposure to energy stocks and trusts in July, soon after the price of oil and natural gas turned down, and that left us with only half our normal exposure to commodities in August. However, that remaining exposure to commodities was in precious metals, and as we discussed earlier there were significant losses to those positions in August.

Although commodities are going through a significant correction, the *long-term* bull market some sectors—especially energy—remains firmly intact. At this point, the same cannot be said about precious metals. So as we shift to a more dollar centric investment strategy, we will be very selective about the commodity exposure we take on, and our overall allocation to commodities will be lower than in the past.

During the decline in oil prices over the past two months, we began increasing our modest exposure to equities by buying large-cap US stocks that met two basic criteria: the stock offered the potential for a positive return, and it paid a significant dividend that would not be at risk from the ongoing credit crisis. As interest rates continue lower and the dollar continues higher, stocks that meet these criteria are likely to offer the best potential return. Although our total exposure to stocks remains small, and we continue to hedge that exposure at times, when the broader market is ready to advance we will increase our allocation to these types of stocks.

At the same time, we have eliminated our allocation to foreign stocks—most of which was in Japan. Although the Nikkei has been able to hold together far better than most other stock markets since January, it has becoming increasingly clear since June that the global economy has entered a synchronized downturn that will probably pull Japanese stocks down as well.

Outside of Japan, the global downturn, the strength of the dollar and the weakness in commodities has made just about every other foreign market unattractive for dollar-based investment. During this equities

bear market our allocation to foreign stocks will remain low or non-existent, and during periods when stocks rebound we will continue to focus on US stocks.

And lastly, we increased our allocation to Treasury bonds significantly earlier in August. With the dollar having turned up and every other part of the market in deflation, the risk to holding Treasuries has decreased dramatically. Even with the recent take over of Freddie Mac and Fannie Mae, Treasury yields remain near all-time lows and look prepared to move lower.

Commodities Focus I

As a pure commodities portfolio, Commodities Focus I has been hit hard over the past few months. Just about every commodity sector has declined significantly over the past month, and this correction appears to have some more to go.

We have cut back on our overall exposure, and now carry a 45% allocation to our Core Stocks with the rest of the portfolio in cash. Most of these stocks are in energy, and the long-term energy bull market remains firmly intact. Oil prices have come down to near \$100/bl from a high near \$148/bl, and in the short-term a decline down to \$80/bl is possible. This would represent a 50% decline from the high, similar to the correction in 2001.

The important thing to keep in mind is that the long-term fundamentals for the bull market in oil and energy have not changed, but the short-term pressures from a rising dollar and a global downturn are having their effect. This means that this downturn will eventually provide us with another long-term buying opportunity, but until that buying opportunity arrives we will remain more conservatively positioned until it is clear a new durable uptrend is emerging.

Dividend Growth

Dividend Growth remains 50% invested in large-cap dividend stocks, with the rest of the portfolio in cash. The stock market is currently near its lows of the year, and from this we could see a seasonal rally emerge or we could see stocks break the low they set in July and continue down. If stocks begin to rally we will invest the 50% of the portfolio into our group of growth stocks, but if stocks break down we will hedge our existing allocation to dividend stocks to limit losses.

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These past few months have been an extraordinary time in the markets, and those who recognize how the markets have changed will be the better off for it in the next couple years. We are making those changes and will be closely monitoring all these new trends to make sure they continue.

If you have any questions about your account or topics raised in this letter just let us know – we'd be glad to hear from you.

Sincerely,
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